THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC4 – Corporate Governance, Assurance & Ethics

June 2019

Answer 01

Relevant Learning Outcomes/s; 2.5, 2.4,2.1
Study text reference: 228-240, 267-277, 387,

(a)

Answers to parts (i) and (ii) are given in the following table:

(i) Risk	(ii) Mitigating Plans
Economic instability The Auto sector has a strong positive correlation with macroeconomic factors. Per capita income, employment levels, size of middle class, interest rates are the major economic parameters that affect this industry. Normally, a stable country with low political risk may encourage foreign investment whereas countries with a high political risk and instability may discourage foreign investment.	Enter into an insurance arrangement to protect investors, financial institutions and international companies in case of events promoting financial loss, such as acts of expropriation, domestic or international political unrest and violence, capital repatriation, etc. Have a list of backup suppliers located in other regions - By building relationships with multiple vendors of the same product, company's stability in terms of production schedule and budget can be assured.
Financial risk Changes in the economic environment of the country such as changes in exchange rates, inflation and interest rates have an impact on the performance of the company. For example, in the case of a rise in exchange rates, the imports costs will go up and therefore the local price also affects. This will negatively impact on customers' demand, revenues and profits of the company.	Continuous monitoring of changes in the macroeconomic environment and developing corporate plans based on these changes. Enter into forward currency/interest rate contracts with financial institutions for importation of motor cycles and spare parts.
Maintaining market share and aggressive competition Competitive pressure - new entrants are there, and also due to rapid change in technology, new models like Scooters are introduced. Customers will be attracted to these and there will be price competition, and reduction in demand.	Enhance product delivery and service offerings to customers by offering value added services that will attract them. Also, increase customer awareness on different models of motor bikes and their benefits compared to competitive models.
Maintenance of quality of the product, service quality and operational efficiency	

Operational efficiency has an impact on profits, as it will affect the costs of the business. Further, if quality standards are not met, there will be an impact on customer satisfaction leading to reputational issues. For example, lack of use of new technology and tools in providing customer services may affect positive attraction of customers.	Continuous improvement of the systems, products, processes, and provision of training to the employees. Also, increase in investment in new technology while shutting down out of date/inefficient processes, tasks.
Human resources related risk Attraction of skilled employees and retention - new competitors will enter and attract trained and skilled employees from existing companies by the use of attractive remuneration packages. The loss of employees will have an impact on the business operations of the company, as it will be unable to provide the required services etc., at the desired level of quality.	Identify skilled employees and have career planning, which should be supported with adequate remuneration and the provision of overseas training opportunities. Provide opportunities for competent employees to attend on foreign industry related trainings and workshops.
Technology and data protection risk Failing to keep pace with developments in technology could impair the competitive position and operations.	Introduce new applications and IT controls. Continuously monitor IT and technology risks and implement a disaster recovery plan and business continuity plan. Increase the fund allocations for investment in new technology and research and development activities.
Compliance risk Implications that arise due to noncompliance with regulatory requirements will result in high costs and also adversely impact reputation. These include import, export tariff, sales and excise duty, etc.	Regularly review statutory compliance by the key management personnel. Implement a mechanism to review compliance with laws and regulations, on a monthly basis and report to the Board of directors on findings and mitigating actions. This could be part of internal audit function.
Supply Chain Disruptions Stoppage, disasters, supplier financial stress, suppliers' union issues are some of the external factors that may lead to supply chain disruptions. The occurrence of any of these events in the major markets from which a firm purchases materials, parts, components and supplies for the manufacture of its products or in which its products are produced, distributed or sold, may result in disruptions and delays in the operations of firm's business.	Close monitoring and discussions of various suppliers, enter into binding agreements, provide training and education to suppliers are certain measures that could be implemented.

(b)

Section in the Question	(i) What Could Go Wrongs (WCGWs)	(ii) Key audit procedure/s
1,2,3	I. Sales are recorded for goods which have not been delivered/sales are recorded when the deposits are received. Unauthorised or inappropriate contractual arrangements may be established. II. Lack of segregation of duties, which may result in inappropriate actions by unauthorized personnel. III. Invoices are marked as paid in full based on internet summary and sales records. The day's internet sales summary is not agreed with invoices posted to the ledger and credit card collection summary. As a result this will lead to uncollected revenue.	• Select a sample of copies sales invoices, and vouch to supporting documentation, **(a)** compare data on the sales invoice to the sales day book, customer orders, dispatch and other supporting documents and **(b)** review the sales invoices for evidence of approval, clerical accuracy, terms and prices and credit limits. • Select a sample of goods dispatched notes, including a number of items around the year end (cut off test) and vouch to supporting documentation, **(a)** ensure details are correctly reflected on the sales invoice; **(b)** agree invoices through to the sales ledger and general ledger **(c)** Ensure items are properly approved and accounted for in the correct period. • Obtain a sample of contracts entered during the year and check whether those contracts have been approved by an appropriate person.
4	I. Incorrect sales reports or/and commission rates have been applied for incentive calculations II. Fraudulent / fictitious sales transactions can be recorded.	I. Obtain sales incentive computations and independently test the accuracy of calculations, on a random basis. II. Review a sample of incentive calculations. schedules/workings to ensure whether those have been approved by an appropriate person.
5,6	i. Accounting estimates and monthly management accounts are not reviewed	i. Obtain a complete list of journal entries made for the year and select journal

	and approved by a senior managerial person/Board of the company. This will leave room for incorrect accounting estimates and incorrect management accounts. Accounting entries are not adequately supported. ii. Invalid or unauthorized accounting entries are recorded, resulting in misstatements. iii. Lack of segregation of duties, which may result in inappropriate action by unauthorized personnel.	entries/other adjustments that appear unusual and obtain an understanding of the reason for the adjustments. ii. Check supporting documents and approvals for those accounting entries. Also, review the general ledger to ensure that appropriate accounting entries have been made. iii. Review the reasonableness of calculations performed for inventory and debtors provision.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes/s; 5.1,5.2, 1.8	
Study text reference: 344-359,651-652, 400-406, 191	

(a)

Acceptance procedures

Ringtel who has requested K&J to undertake two engagements will be a new client. Since K&J has not previously worked with Ringtel, and if K&J is to accept the audits, it will cover financial activities relating to the previous management, the following needs to be considered before accepting Ringtel as K&J's client;

- K&J does have prior experience, knowledge on telecommunication industry as APB is a present telecommunication client of K&J. However, if Ringtel is to be accepted to perform the statutory audit, K&J needs to consider the availability of resources and time. Since concurrently serving two telecommunication audit clients may result in potential resource constraints as these engagements require a larger involvement of staff and other resources (e.g. computers). Therefore K&J shall consider if it can meet the expectations of the new client and whether there are other options to resolve any matters relating to resource requirements.
- K&J should be independent in providing audit services. Presently Ringtel is the telecommunication service provider of K&J and it is essential to assess whether these services have been obtained under normal course of business or whether the services have been negotiated under special terms. Accordingly K&J should assess whether the present relationship will impair "objectivity" as the auditor, when providing the required services and if yes, what safeguards should be in place.
- The spouse of one K&J partner is the Finance Manager of Ringtel who has significant influence over the financial reporting of Ringtel. Therefore, there will be a conflict of interest if that partner becomes the engagement partner of the audit and the completion audit. Therefore, K&J needs to ensure that the partner appointed is not the spouse of the Finance Manager.
- It is important that K&J understands the control environment of Ringtel, particularly the integrity of the management. One of the directors is having a close relationship with a government minister and this director can be considered as a politically exposed person (PEP). Involvement with politically exposed persons will expose K&J to other risks, especially on reputation if a wrong/inappropriate conclusion is reached in the audits. Therefore, it is important that K&J considers the risks associated, and what measures could be taken to mitigate the risks.
- There could be independency as K & J will perform both the completion and statutory audit. The completion audit is mainly to determine the purchase consideration. Hence it is essential to consider whether these engagements could be performed without impairing independence. K & J shall consider whether these engagements could be performed by two separate engagement teams.

(b)

- Since this consists of financial statements prepared based on the provision in the sales and purchase agreement and requires auditing of other statements, this cannot be considered as general purpose financial statements.
  These financial statements are for specific users. Therefore, audit report cannot be issued under SLAuS 700.

- Therefore, the reporting should be under the 'Special purpose framework' and under SLAuS 800

(c)

- Human resources – presently there are vacant positions arising from high level of resignations. This indicates there is an issue on recruitment and retention of staff at K&J.
- Engagement performance - SLAASMB has communicated certain issues on engagement performance, quality issues, and errors in audit reports. There are issues on engagement performance which is another element of quality control systems.
- Leadership – From the given facts the senior partner handles a majority of the audit portfolios. There is a reasonable concern whether due to the other responsibilities whether the senior partner has sufficient time to commit to ensure the quality of the engagement. Further there is no indication that a culture which stresses the importance of quality has been established and as a result most issues have arisen.
- Monitoring – Although there are established policies relating to independence, risk management and quality, there is no indication that these are being monitored. If proper monitoring mechanisms had been in place most of the issues would have been avoided.

(d)

Issue	**Response**
Human resources	• A staff recruitment plan to be drawn up to analyze the staff recruitment needs, potential resignations and for regularly monitoring of the workforce. This plan also should include the activities to be carried out to attract new recruits. • There must be a policy and process for staff promotions, development and compensation for high performers. This requires formalized processes to conduct performance evaluations and to determine the compensation and other career development opportunities based on the results of the performance evaluation processes.
Leadership	• The present client portfolio of the senior partner to be reallocated, as 60% of the portfolio of audit engagements to be distributed among other partners whilst the senior partner retains 40%. This will have an impact on audit quality. • Considering the present issues on quality, there should be regular communications with the senior

	partner on matters relating to quality. The communications by way of frequent meetings with other assurance partners and staff to discuss matters affecting the quality of the assurance practice need to be implemented.
Engagement performance	• Implement effective policies and procedures relating to proper reviews by the partners and managers before issuance of audit opinions. • K&J can have a policy on reviewing qualified audit opinions by an independent/assigned technical partner before these are issued. • Provide required training to staff and partners on application auditing standards when performing the audits. • Regular communication and awareness activities on the application of complex auditing standards in performing the audits. • Develop an audit manual and programs that could be accessible to all partners and staff.
Monitoring	• Since there are established policies, K&J shall design monitoring procedures to ensure policies are implemented and complied with. • K&J shall have an internal quality control program to ensure all engagements comply with quality requirements, for this putpose peer reviews could be carried out on a regular basis for selected engagements. • Appoint a senior competent person who will be responsible for the quality monitoring process of K&J. The person should have appropriate authority and experience.

(e). K&J has introduced a new service line to its practice, for which certain promotions and advertising activities are carried out. Presently there is one trained partner with one resource to provide the required service and the practice has been just established. However, in its promotional material it is mentioned that there is a team of experts. In promoting this service widely in the market, it has not taken into account the present capacity. This indicates there are issues on compliance with fundamental principles of ethics, such as integrity as the promotional activities carry false information.

K&J has made exaggerated claims for services offered, resources, and experience of K&J (e.g. referring to world class service when the service is quite new to K&J). At the early stage of the service it has set out on a mass promotional campaign expecting to secure more jobs relating to this new service. It has not considered whether it has the full capacity to serve customers on a large scale.

Although K&J is not prohibited from competing with others, it should be a fair competition. However, its promotional materials indicates that its services are superior to its competitors. It has made disparaging references or unsubstantiated comparisons to the work of another. This is not in accordance with ethical principles applicable to accountants in professional practice.

(Total: 25 marks)

Answer 03

Relevant Learning Outcomes/s; 1.2,3.3,1.8,3.2,3.4,4.2,4.7
Study text reference: 93-94, 356, 205-206,376-389,591-593, 707-709

- The ultimate leadership of an organization rests with the Chairman and CEO. The Chairman of CBC is a well-qualified and experienced person who is the founder of CBC.
  The Company has operated well. With the expansion of the activities of CBC and considering the investments made by other parties, especially by a foreign party there is a concern whether he has looked at the interests of all shareholders and other stakeholders. The given facts indicate he has a dominant role in CBC.

  The Chairman's role is to preserve good corporate governance. The Chairman shall conduct Board procedures in a proper manner, for e.g. developing appropriate agendas with sufficient details for Board meetings. The scenario does not indicate whether this is happening frequently.

- Presently one foreign shareholder is planning to quit from the company citing that there is no equal treatment for all shareholders as he does not get a sufficient return for his investment.

  Therefore, the Chairman has not been able to manage the expectations of all shareholders and has not been able to ensure a fair treatment of all shareholders which is not a good sign of good corporate governance.

- Although CBC is presently not a public listed company, as it has some expectations for listing it is important to look at all aspects of corporate governance. Corporate governance codes recommend that there should be a clear division of responsibilities between the Chairman and the CEO.

  At CBC, the Chairman acts as the CEO. According to the information given the Chairman has full control over operations. However, if the company is to adopt good corporate governance practices it must work collectively in the best interest of the company.

- The Chairman is responsible to ensure a proper balance on the Board.
  The present Board composition does not indicate that there is a proper balance with reference to the shareholding. Further, the Board does not have a proper composition in terms of executive and non-executive directorships. Further no independence directors are involved.

- The Chairman has not considered having Board sub committees especially an audit committee and a remuneration committee. As a result there is no proper structure in place to ensure the independence of the auditors.

  The Chairman has a close relationship with its auditors and the audit partner's son is the Marketing Manager of CBC. Therefore, the Chairman has undermined the independence of the auditors. On the other hand from the given facts it seems that a fair remuneration policy is not in place as only the local directors are remunerated and not the foreign directors

(b) Risks associated with politically exposed persons (PEPs) need to be mitigated across the organization. The audit team should carry out the following audit procedures to cover audit risks:

- Examine the company's compliance with documented policies and procedures, which could highlight non-compliance as well as gaps in key controls.

- Obtain a listing of PEPs to determine if the required KYC is on file and periodic reviews are being performed in accordance with the company's periodic review schedule.

- Review minutes of meetings of the Board of Directors and Management and check whether there were discussions on transactions/arrangements with PEPs.

- Discuss and review whether the in-house internal audit team has focused on reviewing controls surrounding this area and discussed any findings.

- Senior Manager of the engagement team should discuss with the Chairman of the company with regard to the transactions with PEP.

(c) Before accepting this engagement, there are several matters to be considered. A significant matter is whether it is ethically acceptable to conduct the due diligence review. This would constitute a non-assurance service provided to an audit client, and the CA Sri Lanka's Code of Ethics for Professional Accountants states that this may create a threat to independence. If an engagement is carried out by the external auditor it will result in a self-review threat. Also, the objectivity of the auditor will be affected as there will be bias and/or undue influence on the proper conduct of the engagement.

In accepting this engagement, the firm should also consider whether there are staff available with appropriate skills and experience to perform this engagement.

The engagement should only be provided if safeguards can be used to reduce the threat to an acceptable level, which may include:

- Having a professional accountant who was not involved with the statutory audit work performed or otherwise advise as necessary.

- Discussing ethical issues with those charged with governance of the client.

- Using separate teams to work on the statutory audit and on the due diligence engagement.

(d)

Title of RMM	Reasons for Identifying as a RMM
Revenue recognition	Due to the nature of operations, a high volume of transactions exist. Sales are made through dealers/agents and there is pressure to show better performance. Therefore, there is an inherent fraud risk of overstatement of revenue.
Noncompliance with laws and regulations	The government has imposed increased excise duty on imports and there are concerns on not purifying the waste water. The company has received income tax assessments from Inland Revenue Department which may result in an additional tax liability. Further, the management is planning to reduce the number of employees through a voluntary retirement scheme in which certain regulatory requirements should be followed.
Impairment of property, plant and equipment and Outlets (i.e. two business units, manufacturing and retail)	The Company has invested a considerable sum of money on the acquisition of plant and equipment and is continuously doing it to facilitate future production. Due to a decline in performance and/or technological obsolescence, there is a risk that those assets may have been impaired. Further, it appears that the recent performance of the manufacturing arm is not at the expected level, which may trigger a possible impairment of the manufacturing business segment.
Completeness and disclosure of related party transactions	As per the pre-seen information, the directors have reimbursed their personal expenses such as their children's school fees, vehicle rentals, overseas trip expenses and other drawings as allowances in addition to the dividend payment. Discussions are also in progress for share transactions among shareholders. Therefore, it appears that certain related party transactions exist.
Management override of controls	There is a possibility of manipulating financial records by processing unauthorized or unusual journal entries to overstate the performance. Inaccurate data and unrealistic assumptions may be applied in computing complex accounting estimates to reflect better financial performance.
Valuation of land and buildings	The Company owns land and buildings which are included under property, plant, equipment and investment properties. The management has discussed about the reasonability of the recent valuation of those properties.

	Therefore, there is a risk of over valuing the properties to show a stronger financial position.
Valuation of inventory	From there verifications and other audit procedures, internal audit team had noted certain slow moving and obsolete items. Also, through their communication with the Chairman, the Accounting Standards Monitoring Board has requested clarification on inventory provisioning. Therefore, there is a risk on the valuation of inventory as at reporting date.
Accounting for tax	Due to inherent nature, there is a risk that tax liability has not been reported properly in the financial statements. Also, recent assessment from IRD will have an impact on tax liability reported.
Accounting for deferred tax	Due to recent changes to the income tax act, an additional deferred tax liability may arise on the revaluation surplus.
Impairment of Trade and other Receivables	There is a significant increase in trade and other receivables during the year, which may indicate slow collections, thus possible impairment/provision for bad debts. Further, as per the requirements of SLFRS 9, a bad debts provision needs to be assessed referring to the simplified method, which may warrant a more significant increase in the provision.
Retirement Benefit obligation	With the restructuring that took place during the year, certain employees have been retired under the voluntary retirement plan. Therefore, the number of employees and assumptions used for actuarial valuation of the current year will change significantly compared to the last year. Further, there is a significant movement in the actuarial gain/loss for the year compared to last year.

(e)

<u>Valuation of Land and Buildings</u>

- Assess the competency, capability and objectivity of the external valuers engaged by the company.
- Read the external valuer's report and understand the key estimates made and the approach taken by the valuers in determining the valuation of each property.
- Engage auditor's specialised resources to assess the reasonableness of the valuation techniques, per perch price and value per square foot.
- Assess the adequacy of the disclosures made in the financial statements relating to the valuation technique and estimates used by the external valuers.

<u>Impairment of Property, Plant and Equipment</u>

- Evaluate the cash flow forecasts and the process by which they were developed, including considering the mathematical accuracy of the underlying calculations;

- Compare cash flow forecasts to the latest Board approved budgets and also ensured that the underlying cash flow forecasts, assumptions used and conclusions reached have been reviewed and approved by the Board;
- Review the reasonableness of fair values of assets and liabilities of the related outlets in arriving at the net assets of those related outlets;
- Assess the reasonableness of key assumptions including the discount rate, terminal growth rates and forecast growth assumptions. Also perform a sensitivity analysis for the cash flow forecasts and assumptions, where necessary.

Reliance on Automated Processes and Controls

- Gain an understanding of the IT environment of the company, including the extent of the use of IT for financial reporting and related accounting software systems used.
- Review and evaluate the effectiveness of IT general controls in place and the safeguarding of hardware and software items.
- Evaluate the design and test the operating effectiveness of the application controls by performing additional audit testing procedures.

Tax Provisions

- Understand the company's process for determining provisions for tax and calculate the tax charge, and walk through management's controls over tax reporting.
- The audit team, including tax specialists, evaluate the tax positions taken by management in each significant jurisdiction in the context of local tax law, correspondence with tax authorities and the status of any tax audits.
- Assess the company's transfer pricing judgements, considering the way in which the company's businesses operate and the correspondence and agreements reached with tax authorities.
- Assess the appropriateness of the disclosures included in the financial statements in respect of current and deferred tax balances.

Valuation of Employee Benefits

- Evaluate the professional qualifications, competencies and independence of the actuary.
- Evaluate /test the reasonableness of assumptions applied, through inquiries, Re performing calculations etc.
- Review the reliability and completeness of data and information used for valuation.
- Examine whether disclosure has been made in the financial statements.

(f) During the stage of performing audit procedures and obtaining audit evidence, the auditor must keep a track on differences in balances and transactions which are above the set materiality. If any difference is noted above the materiality level, then those differences should be discussed with management for necessary adjustments.

Among the differences, priority should be given to adjust factual misstatements as those are clear differences. In this scenario, the audit team must explain to the management about adjusting the differences raised with regard to under provision of operating expenses and the exchange loss on the debtor's valuation.

For judgmental differences, the auditor must discuss with the client and make a request to re-visit their assessments to bring down the differences to an acceptable level.

If the management is not willing to adjust any of the differences/or certain differences, then the audit team should maintain a summary of those adjustments for final evaluation.

After completion of the audit field works, those unadjusted differences should be assessed individually and in aggregate to ascertain whether there is a material impact on those items for the overall financial statements. Depending on such assessments, the auditor must take appropriate steps to conclude on those items.

This may involve either issuing a modified audit opinion or report the issues to management through the management letter. A modified opinion will be expressed on those unadjusted differences, if the overall impact is material for the financial statements.

(g) (i)

The auditor has included an emphasis of matter paragraph in the audit report, which is not acceptable.

An emphasis of matter paragraph is included to draw the users' attention to a matter or other matters presented or disclosed in the financial statements that the auditor judges as important to their understanding of the financial statements and it is not about a material misstatement in the financial statements. Therefore, including an emphasis of matter does not constitute a qualification of the audit report.

(ii)
According to the summary of audit differences, the unadjusted provision for inventory and impairment of machineries were Rs. 1,328,000 and Rs. 1,460,000 respectively. It seems that there was a significant issue on the management's assessment of those areas last year. Both the differences are below the performance materiality, individually but above performance materiality, in aggregate. In this situation, the audit team should consider performing other alternative procedures to ensure the reported differences are reasonable.

For example for the inventory provision, a review of recent years provisions to the carrying value ratio, review of past write offs, etc. There are alternative procedures that can be performed to validate the reasonableness of the impairment provision for machineries, for example, review the number of production units recommended by the manufacturer, analysis of future cash flows, review the trend in repairs and maintenance of machineries, etc.

If the differences still exist, then the audit team must discuss with management and make a request to revisit the assessments, as those are projected differences, the audit team should not ask the client to adjust for the differences reported, but request them to revisit the assessments and adjust the balances to bring the net difference to an acceptable level.

If the management is not willing to adjust the balances, then there is a significant judgmental difference which has a material impact on the audit opinion of the financial statements. In that situation, the audit report should be modified, by expressing a qualified opinion referring to the inventory provision and impairment of machineries.

(Total: 50 marks)

Notice of Disclaimer

The answers given are entirely by the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) and you accept the answers on an "as is" basis.

They are not intended as “Model answers’, but rather as suggested solutions.

The answers have two fundamental purposes, namely:

1. to provide a detailed example of a suggested solution to an examination question; and

2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) makes no warranties with respect to the suggested solutions and as such there should be no reason for you to bring any grievance against the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka). However, if you do bring any action, claim, suit, threat or demand against the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka), and you do not substantially prevail, you shall pay the Institute of Chartered Accountants of Sri Lanka's (CA Sri Lanka’s) entire legal fees and costs attached to such action. In the same token, if the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) is forced to take legal action to enforce this right or any of its rights described herein or under the laws of Sri Lanka, you will pay the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) legal fees and costs.